



# Ares Capital Corporation (ARCC)

Updated February 9<sup>th</sup>, 2023 by Samuel Smith

## Key Metrics

<b>Current Price:</b>	\$20.0	<b>5 Year CAGR Estimate:</b>	7.7%	<b>Market Cap:</b>	\$10 B
<b>Fair Value Price:</b>	\$21.0	<b>5 Year Growth Estimate:</b>	-1.6%	<b>Ex-Dividend Date:</b>	03/14/23
<b>% Fair Value:</b>	95%	<b>5 Year Valuation Multiple Estimate:</b>	1.0%	<b>Dividend Payment Date:</b>	03/31/23
<b>Dividend Yield:</b>	9.6%	<b>5 Year Price Target</b>	\$19	<b>Years Of Dividend Growth:</b>	2
<b>Dividend Risk Score:</b>	F	<b>Retirement Suitability Score:</b>	C	<b>Rating:</b>	Hold

## Overview & Current Events

Ares Capital Corporation is a US-based closed-ended specialty finance business development company (BDC). It focuses on generating both current income and capital appreciation through debt and equity investments. The company invests primarily in U.S. middle-market companies, as well as larger companies. Its portfolio is comprised of first and second lien senior secured loans as well as mezzanine debt, diversified by industry and sector. The company was founded in 2004 and has a market capitalization of \$10 billion.

On February 7th, 2023, Ares Capital Corp. reported Q4 and FY2022 results. Q4 core EPS was \$0.63, beating the \$0.56 consensus, and rose from \$0.50 in Q3 and from \$0.58 in the year-ago quarter. Net investment income of \$349M, or \$0.68 per share, climbed from \$288M, or \$0.57 per share, in Q3 and from \$242M, or \$0.52 per share, in Q4 2021.

Net unrealized gains of \$26M, or \$0.05 per share, compared with unrealized losses of \$184M, or \$0.36 per share, in the prior quarter and unrealized gains of \$16M, or \$0.04 per share, in the year-ago period. Portfolio investments at fair value were \$21.8B as of Dec. 31, 2022, vs. \$21.3B at Sept. 30. Net assets per share of \$18.40 at the end of Q4 declined from \$18.56 as pf Sept. 30. The debt/equity ratio was 1.29x vs. 1.27x at the end of Q3.

## Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
<b>EPS</b>	\$1.83	\$1.94	\$1.20	\$1.51	\$1.57	\$2.01	\$2.03	\$1.87	\$2.02	\$2.02	<b>\$2.33</b>	<b>\$2.15</b>
<b>DPS</b>	\$1.52	\$1.52	\$1.52	\$1.52	\$1.52	\$1.54	\$1.60	\$1.60	\$1.62	\$1.92	<b>\$1.92</b>	<b>\$1.92</b>
<b>Shares<sup>1</sup></b>	267	305	314	314	425	426	431	423	479	508.3	<b>508.3</b>	<b>550</b>

The likelihood of future upward pressure on interest rates due to inflation offer a tailwind to earnings power given that the vast majority of their investments are floating interest rate debt.

That said, the current uncertainty and headwinds hanging over the economy combine with the company's choppy earnings history to make us cautious of the company's growth prospects. As a result, we assume an annual growth rate of just -1.6% over the next half decade, as well as an increasing share count over that period.

## Valuation Analysis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Now	2028
<b>Avg. P/E</b>	8	9.7	8.1	11.8	10.9	10.1	7.7	9.2	9.3	11.9	<b>8.6</b>	<b>9.0</b>
<b>Avg. Yld.</b>	8.5%	8.6%	9.7%	10.7%	9.2%	9.6%	10.0%	8.6%	9.2%	7.6%	<b>9.6%</b>	<b>9.9%</b>

Ares Capital has a history of strong outperformance of peers and the S&P 500, returning approximately 1.5 times the S&P's total return with average annual total returns of ~12% since the company was formed in 2004. This track record, along with its recent NAV per share growth would normally make it worth paying a small premium for. The stock is currently trading at a slight discount to our estimated Price to Earnings ratio fair value multiple.

<sup>1</sup> Shares in millions

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## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
<b>Payout</b>	83%	78%	127%	101%	97%	77%	79%	86%	80%	95%	82%	89%

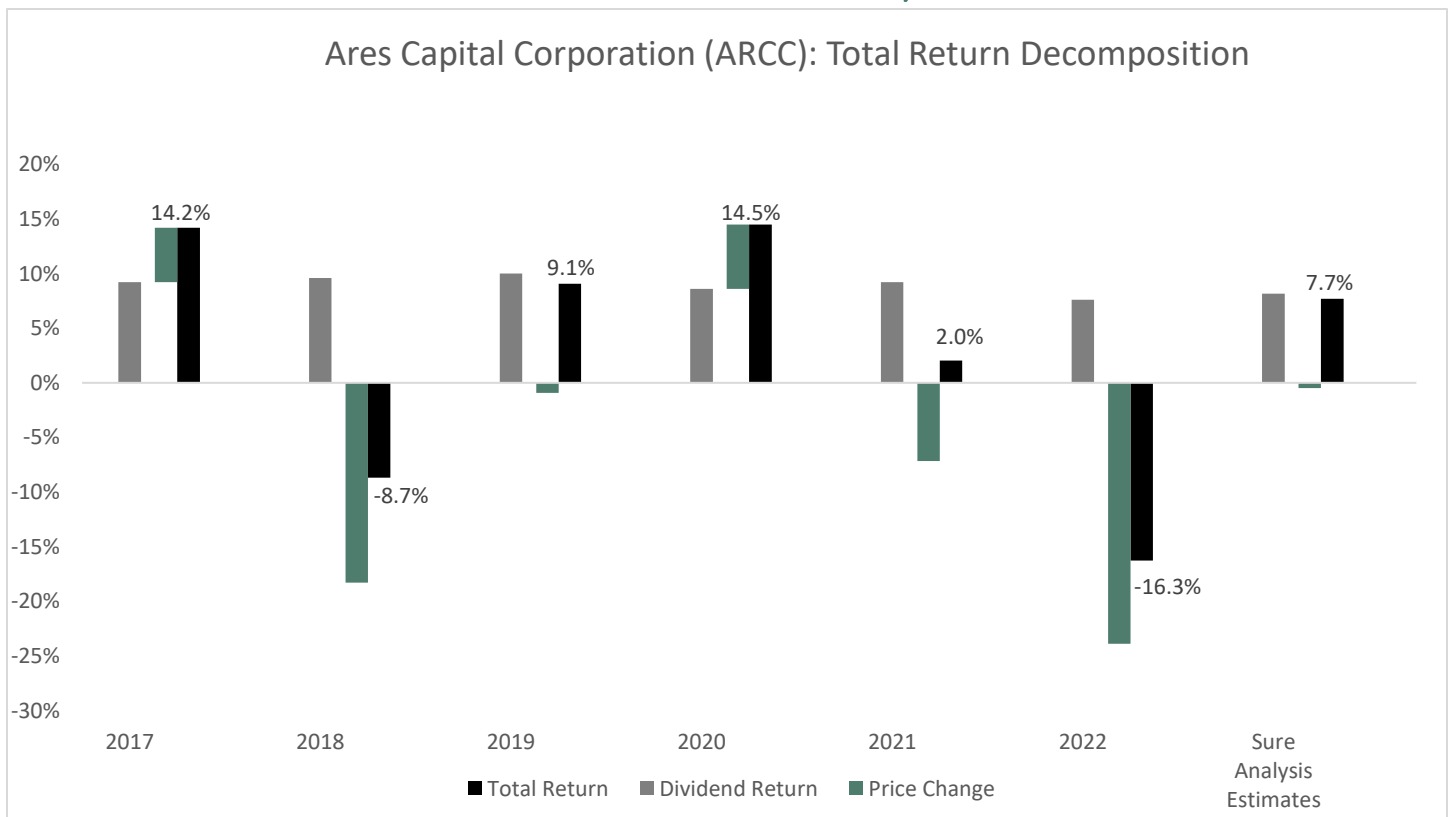
Ares Capital is arguably the safest BDC given that it is the only one with investment-grade ratings from all three major rating agencies. Additionally, its balance sheet is in a very strong position with solid and stable asset quality and a diversified long-duration liability structure. It also has very diversified holdings with weighted average interest coverage of over 2 times, minimizing default risk. Its competitive advantage comes from its superior size and scale as one of the largest BDCs.

While earnings and dividends fell during the last recession, it performed fairly well relative to its peers as the dividend only fell moderately. As a result of management's experience and track record of mitigating losses and rebounding fairly quickly from the last recession, we view Ares Capital as a lower-risk BDC to hold at this stage in the cycle. This conclusion is also supported by its solid balance sheet and diversified portfolio.

### Final Thoughts & Recommendation

Given Ares Capital's moderate risk profile, experienced management, and commitment to supporting the share price and growing the dividend, it makes for an interesting investment for income investors. Its 9.6% dividend yield provides investors with attractive income and combines with our expectation of low single digit multiple expansion offset by low single digit annualized earnings per share declines to generate expected total annualized returns of 7.7% for the next half decade. As a result, we rate it as a Hold. That being said, the BDC business model does tend to struggle during recessions, so conservative investors definitely should keep that risk in mind.

### Total Return Breakdown by Year



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## Income Statement Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
<b>Revenue</b>	652	768	572	674	883	1,048	1,018	725	1,903	789
<b>SG&amp;A Exp.</b>	149	159	165	179	223	211	239	222	264	38
<b>Net Profit</b>	489	591	379	474	667	858	793	484	1,567	600
<b>Net Margin</b>	74.9%	77.0%	66.3%	70.3%	75.5%	81.9%	77.9%	66.8%	82.3%	76.0%
<b>Free Cash Flow</b>	(1,298)	(659)	360	707	(2,048)	304	(1,235)	(580)	(2,459)	(1,359)
<b>Income Tax</b>	14	18	18	21	19	19	16	19	29	55

## Balance Sheet Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
<b>Total Assets</b>	8,142	9,498	9,507	9,245	12,347	12,895	14,905	16,196	20,843	22,398
<b>Cash &amp; Equivalents</b>	150	195	257	223	316	296	167	254	372	303
<b>Total Liabilities</b>	3,237	4,214	4,334	4,080	5,249	5,595	7,438	9,020	11,975	12,843
<b>Accounts Payable</b>	112	129	113	102	245	155	177	179	427	294
<b>Long-Term Debt</b>	2,986	3,924	4,114	3,874	4,854	5,247	7,092	8,573	11,137	12,320
<b>Shareholder's Equity</b>	4,904	5,284	5,173	5,165	7,098	7,300	7,467	7,176	8,868	9,555
<b>LTD/E Ratio</b>	0.61	0.74	0.80	0.75	0.68	0.72	0.95	1.19	1.26	1.29

## Profitability & Per Share Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
<b>Return on Assets</b>	6.7%	6.7%	4.0%	5.1%	6.2%	6.8%	5.7%	3.1%	8.5%	2.8%
<b>Return on Equity</b>	11.0%	11.6%	7.2%	9.2%	10.9%	11.9%	10.7%	6.6%	19.5%	6.5%
<b>ROIC</b>	6.9%	6.9%	4.1%	5.2%	6.4%	7.0%	5.9%	3.2%	8.8%	2.9%
<b>Shares Out.</b>	267	305	314	314	425	426	431	423	479	508.3
<b>Revenue/Share</b>	2.44	2.52	1.82	2.15	2.08	2.46	2.38	1.71	4.27	1.52
<b>FCF/Share</b>	(4.86)	(2.16)	1.15	2.25	(4.82)	0.71	(2.89)	(1.37)	(5.51)	(2.62)

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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